

§ 1.731-2 Partnership distributions of marketable securities.

(a) *Marketable securities treated as money.* Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term money includes marketable securities and such securities are taken into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money—(1) Aggregation of securities.* For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction.* The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain.* For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities—(1) In general.* For purposes of section 731(c) and

this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded.* For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if XYZ common stock is listed on a national securities exchange, particular shares of XYZ common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity—(i) Substantially all.* For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all.* For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets.* For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions—(1) In general.* Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule.* Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security.* Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and

this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships.*—(1) *In general.* Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner.*—(i) *Contributed services.* For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests.* For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities.* For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of—

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board

of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers.* For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules—(1) Partner's basis—(i) Partner's basis in distributed securities.* The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest.* The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property.* No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections—(1) Sections 704(c)(1)(B) and 737—(i) In*

general. If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B).* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737—(A) Marketable securities as other property.* A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737.* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B).* If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will

not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule.* The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no

marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples are as follows:

Example 1. Recognition of gain. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of \$1,000 and an adjusted tax basis of \$250. *B* contributes \$1,000 cash. *AB* subsequently purchases Security *X* for \$500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is \$250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution (\$500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes \$250 of gain under section 731(a)(1) on the distribution (\$500 distribution of money less \$250 adjusted tax basis in *A*'s partnership interest).

Example 2. Reduction in amount treated as money—in general. (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security <i>X</i>	100	70	30
Security <i>Y</i>	100	80	20
Security <i>Z</i>	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized \$40 of net gain (\$30 gain on Security *X* plus \$20 gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$20 (one-half of \$40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have \$10 of net gain (\$20 of gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$5 (one-half of \$10 net gain). As a result, the distribution resulted in a decrease of \$15 in *A*'s

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distributive share of the net gain in AB's securities (\$20 net gain before distribution minus \$5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$15. The distribution of Security X is therefore treated as a distribution of \$85 of money to A (\$100 fair market value of Security X minus \$15 reduction).

Example 3. Reduction in amount treated as money—carried interest. (i) A and B form partnership AB. A contributes \$1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. B contributes \$1,000 in exchange for a 40 percent interest in partnership profits. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	Basis	Gain
Security X	100	80	20
Security Y	100	90	10

(ii) If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized \$30 of net gain (\$20 gain on Security X plus \$10 gain on Security Y). A's distributive share of this gain would have been \$18 (60 percent of \$30 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have \$10 of net gain (\$10 gain on Security Y). A's distributive share of this gain would have been \$6 (60 percent of \$10 net gain). As a result, the distribution resulted in a decrease of \$12 in A's distributive share of the net gain in AB's securities (\$18 net gain before distribution minus \$6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$12. The distribution of Security X is therefore treated as a distribution of \$88 of money to A (\$100 fair market value of Security X minus \$12 reduction).

Example 4. Reduction in amount treated as money—change in partnership allocations. (i) A is admitted to partnership ABC as a partner with a 1 percent interest in partnership profits. At the time of A's admission, ABC held no securities. ABC subsequently acquires Security X. A's interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. A retains a 1 percent interest in all securities acquired before the increase. ABC then acquires Securities Y and Z and later distributes Security X to A in a current distribution. Immediately before the distribution, the securities held by ABC had the following

fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	1,000	500	500
Security Y	1,000	800	200
Security Z	1,000	1,100	(100)

(ii) If ABC had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized \$600 of net gain (\$500 gain on Security X plus \$200 gain on Security Y minus \$100 loss on Security Z). A's distributive share of this gain would have been \$7 (1 percent of \$500 gain on Security X plus 2 percent of \$200 gain on Security Y minus 2 percent of \$100 loss on Security Z).

(iii) If ABC had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have \$100 of net gain (\$200 gain on Security Y minus \$100 loss on Security Z). A's distributive share of this gain would have been \$2 (2 percent of \$200 gain on Security Y minus 2 percent of \$100 loss on Security Z). As a result, the distribution resulted in a decrease of \$5 in A's distributive share of the net gain in ABC's securities (\$7 net gain before distribution minus \$2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$5. The distribution of Security X is therefore treated as a distribution of \$995 of money to A (\$1000 fair market value of Security X minus \$5 reduction).

Example 5. Basis consequences—distribution of marketable security. (i) A and B form partnership AB as equal partners. A contributes nondepreciable real property with a fair market value and adjusted tax basis of \$100.

(ii) AB subsequently distributes Security X with a fair market value of \$120 and an adjusted tax basis of \$90 to A in a current distribution. At the time of distribution, the basis in A's interest in the partnership is \$100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by \$15 (one-half of \$30 net gain in Security X). As a result, A recognizes \$5 of gain under section 731(a) on the distribution (excess of \$105 distribution of money over \$100 adjusted tax basis in A's partnership interest).

(iii) A's adjusted tax basis in Security X is \$95 (\$90 adjusted basis of Security X determined under section 732(a)(1) plus \$5 of gain recognized by A by reason of section 731(c)). The basis in A's interest in the partnership is \$10 as determined under section 733 (\$100 pre-distribution basis minus \$90 basis allocated to Security X under section 732).

Example 6. Basis consequences—distribution of marketable security and other property. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property, with a fair market value of \$100 and an adjusted tax basis of \$10.

(ii) *AB* subsequently distributes Security *X* with a fair market value and adjusted tax basis of \$40 to *A* in a current distribution and, as part of the same distribution, *AB* distributes Property *Z* to *A* with an adjusted tax basis and fair market value of \$40. At the time of distribution, the basis in *A*'s interest in the partnership is \$10. *A* recognizes \$30 of gain under section 731(a) on the distribution (excess of \$40 distribution of money over \$10 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is \$35 (\$5 adjusted basis determined under section 732(a)(2) plus \$30 of gain recognized by *A* by reason of section 731(c)). *A*'s basis in Property *Z* is \$5, as determined under section 732(a)(2). The basis in *A*'s interest in the partnership is \$0 as determined under section 733 (\$10 pre-distribution basis minus \$10 basis allocated between Security *X* and Property *Z* under section 732).

(iv) *AB*'s adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If *AB* made such an election, the aggregate basis of *AB*'s assets would be increased by \$70 (the difference between the \$80 combined basis of Security *X* and Property *Z* in the hands of the partnership before the distribution and the \$10 combined basis of the distributed property in the hands of *A* under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by *A* by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

Example 7. Coordination with section 737. (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of \$200 and an adjusted basis of \$100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of \$120 and an adjusted tax basis of \$100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of \$20 and an adjusted tax basis of \$0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribu-

tion to *A*, the partnership would have recognized \$20 of gain. *A*'s distributive share of this gain would have been \$5 (25 percent of \$20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been \$0. As a result, the distribution resulted in a decrease of \$5 in *A*'s share of the net gain in *AB*'s securities (\$5 net gain before distribution minus \$0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by \$5. The distribution of Security *X* is therefore treated as a distribution of \$115 of money to *A* (\$120 fair market value of Security *X* minus \$5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money (\$5) is treated as other property for purposes of section 737.

(iv) *A* recognizes total gain of \$40 on the distribution. *A* recognizes \$15 of gain under section 731(a)(1) on the distribution of the portion of Security *X* treated as money (\$115 distribution of money less \$100 adjusted tax basis in *A*'s partnership interest). *A* recognizes \$25 of gain under section 737 on the distribution of Property *Y* and the portion of Security *X* that is not treated as money. *A*'s section 737 gain is equal to the lesser of (i) *A*'s pre-contribution gain (\$100) or (ii) the excess of the fair market value of property received (\$20 fair market value of Property *Y* plus \$5 portion of Security *X* not treated as money) over the adjusted basis in *A*'s interest in the partnership immediately before the distribution (\$100) reduced (but not below zero) by the amount of money received in the distribution (\$115).

(v) *A*'s adjusted tax basis in Security *X* is \$115 (\$100 basis of Security *X* determined under section 732(a) plus \$15 of gain recognized by reason of section 731(c)). *A*'s adjusted tax basis in Property *Y* is \$0 under section 732(a). The basis in *A*'s interest in the partnership is \$25 (\$100 basis before distribution minus \$100 basis allocated to Security *X* under section 732(a) plus \$25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

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§ 1.732-1 Basis of distributed property other than money.

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received